Why Loblaw Companies Ltd (TSX:L) Could Have a Rough Q3

Description

Loblaw (TSX:L) got some bad news this week. It learned it will have to incur a $368 million expense as a result of a tax ruling. The Canada Revenue Agency argued that the company's off-shore bank should not have been considered to be foreign and should have been subject to paying Canadian taxes. However, the bill could have been higher, as the courts ruled that Loblaw did not attempt to avoid Canadian taxes.

Loblaw still plans to appeal the decision, but as of now it looks like the company will take a big hit in its financials, which could put its next earnings release into the red.

In its most recent quarter, Loblaw netted a profit of just $53 million, and only once in the past five quarters has it achieved a net income higher than $380 million. With sales also being slightly down as well, it could be shaping up to be a very poor quarter. I anticipated that Loblaw would run into challenges this year, as minimum wage increases were expected to take a bite out of the company's earnings, and Loblaw is still recovering from the price-fixing scandal it admitted to last year.

Why the company is still doing okay

The company's long-term health still remains strong, as Loblaw has done a good job of generating positive free cash flow on a consistent basis. In the trailing 12 months, the company has accumulated more than $1.6 billion in cash from its operations and after capital investments.

However, on the flip side, while this proves the company can get by, that's all it does. Loblaw still has an uphill battle staying competitive with **Amazon.com**, as the online retailer continues to make it easier for shoppers to get their online purchases sooner. And **Walmart** is no slouch either, and with many more resources and it rolling out delivery for groceries, it ensures competition will be even fiercer, which would put more pressure on Loblaw's bottom line.

Should you consider investing in Loblaw?

Overall, the impact of the tax hit will be a one-time item, so the long-term effects will be minimal. The bigger issue for investors is whether or not Loblaw is strong enough to withstand damages to its image as a result of the price-fixing scandal, rising labour costs, and the financial burden that it will take just to remain competitive.

In the past three years, Loblaw stock has dropped over 2% and has done little to reward investors for holding the stock, other than offering a very modest yield of just 1.6%. At this point in time, there's simply no convincing reason to invest in Loblaw. While the stock may trade at just twice its book value and a price-to-earnings multiple of around 20, it's still a bit expensive for a company facing this much risk and uncertainty, not to mention falling sales.

There are better options out there to invest in, and without a big sell-off happening, I don't see Loblaw being a good buy.

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